



Utilities

Utilities/Power/Yieldcos/Water - What we've learned this week

Summary:

AEP's results and comments on the OH political risk bode well for FE. We'd expect solid EEI updates from both, and we're raising our PT for AEP ahead of them. AES's settlement in OH is more impressive than the grid modernization capex would indicate. AGR's proposed acquisition of PNM caught us by surprise, and why the EPS accretion math should work, the addition of NM to AGR's already challenging regulatory jurisdictions surprised us. The deal coupled with commentary from IBE's holders do not bode well for PPL's pending sale of WPD (RAB multiples and a tax shield) though the stock seems to already reflect that. NEE's renewable power growth keeps accelerating and with that the company's need to add regulated utilities. The NEE-DUK deal could look even better after the elections so it's too early to give up on it. SO's updated schedule for its new Vogtle nuke is a bit longer than we had hoped for, but way better than the bear case. And lastly, smid-cap water utilities are getting a technical boost (i.e., AWR, CWT, SJW, WTRG). They do seem undervalued based on fundamentals, but the recent/ongoing move is more about quant screens. Also note that we've updated our models for AEP, NEE, and NEP with this update.

Highlights

AEP (Buy, PT \$99 up from \$96) and FE (Buy, PT \$42) – More regulated renewables at EEI + shedding of OH overhang which bodes well for FE

- There were few surprises from AEP's 3Q20 print, but management plans to comment on AEP's rate based renewable power investments (incremental to the \$2B North Central Wind) during the upcoming EEI conference. It sounds like the company plans to pursue renewable power capex in VA and IN, and besides ESG benefits, it should get AEP's EPS CAGR closer to 7% from the current 6.5%, we estimate.
- AEP seems to have shed most of the overhang related to the HB 6 in OH, and investors seem increasingly hopeful that FE will act the same way. FE delayed its 3Q20 print until Nov 2, the day before the elections with the latter being increasingly seen as a particularly sensitive event in OH.
- We updated our model and our annual estimates for AEP remain unchanged, but we raised our PT to \$99 from \$96 on lower risks in OH. No changes to our estimates/PT for FE as we await management's EEI update.

AES (Buy, PT \$21) – Capex boost in OH is small, but lots of positives from PUCO settlement; regulated capex updates from IPL on 3Q20 call

- DP&L, AES's OH regulated utility, just settled with state utility regulators (PUCO) on grid modernization capex, among others. The utility can now invest \$249MM over the next four years which is small, but that's just a part of DP&L capex program which includes FERC transmission investments. Also, through the settlement DP&L confirmed its ability to continue to collect \$80MM annually under the rate stabilization charge (RSC) and resolved three overearning (SEET) tests. The utility also plans to file another rate case. We expect an update on AES's regulated generation capex in IN (for IPL) on the 3Q20 call.
- No changes to estimates or PT for AES.

AGR (Neutral, PT N/A) and PPL (Neutral, PT N/A) – PNM merger and WPD's valuation

- The PNM acquisition came as a surprise to investors even though everybody seemed aware of IBE's (and thus AGR's) plans to grow its regulated utility presence in the US. A change to the NM utility commission is on the ballot on November 3 – if approved, PNM/AGR could be regulated by three new Commissioners appointed by the Legislature instead of the current five elected Commissioners. That could be an improvement starting Jan 1, 2023, yet the question remains how this potential change should impact the conduct of the current Commissioners over the next 26 months. They will be reviewing the AGR-PNM merger while trying to secure a job on the new downsized Commission. That could mean a longer-than-expected approval process for the deal, investors believe.
- We had openly hoped for a combination of AGR and PPL given IBE's past interest in WPD, PPL's UK distribution networks. Yet, we are hearing from IBE shareholders that the Spanish renewable power major thought the WPD deal would have been too big for them and would have detracted from IBE's renewable power focus. That's bad news for WPD's likely valuation, we believe, as consortiums of financial investors (infra funds) now seem like the most likely buyers of PPL's UK business, and the 1.5x+ EV/RAB seems increasingly unlikely. Then there is the potential Biden win in November and a likely change in the federal tax law which would follow. That in turn could impact the tax leakage associated with the WPD sale. Investors believe that WPD needs to sell above 1.35x 2021 EV/RAB and eliminate practically any tax leakage to create any meaningful shareholder value for PPL at the stock's current share price. And that still seems realistic to us.
- No changes to our recently-updated estimates for AGR. No changes to PPL.

NEE (Buy, PT \$324) – 15GW renewable backlog, but regulated utility M&A dominates investor minds

- NEER keeps adding new storage/wind/solar contracts, and the accelerating growth in those unregulated contract-based operations continue to fuel questions on regulated utility M&A. Stand-alone ITCs for storage projects on the back of Biden's wind could lead to retrofits of NEER's existing wind farms thus further boosting the NEER growth. Management emphasizes no pre-set earnings mix or credit concerns, but depending on the outcome of November elections (both federal and state), the NEE-DUK merger rationale could get another boost. As we mentioned in our recent [note](#), investors are increasingly optimistic on this eventual combination.
- We updated our model for NEE and our annual estimates and PT for NEE (and DUK) remain unchanged as we await the eventual outcome of November elections.

NEP (Buy, PT \$70) – 15% YoY growth in 4Q20 distributions/share

- The 3Q20 wind (96% of normal) and solar power generation dropped YoY which was in line with our below-consensus expectations for NEP and other yieldcos. Yet, NEP delivered on a 15% YoY growth in unit distributions per share and its ~70% payout ratio leaves plenty of room to continue the ~15% annual growth in distributions through 2022 without any additional outside project acquisitions. It also helps that NEP pursues organic growth through the repowering of a 125MW wind project in CO or an addition of backup compression capacity at the Agua Dulce gas compressor station, both just completed ahead of schedule and on budget. The repowering of the 100MW Baldwin wind farm in ND should be complete by the year-end.
- We marginally increased our 2020/2021 EBITDA estimates for NEP following the 3Q20 print to \$1,263M/\$1,291MM up from \$1,260MM/\$1,289MM, respectively. Our PT remains unchanged.

SO (Buy, PT \$66) – Pressurization of Vogtle Unit 3 and operations of its steam generator will start only in January 2021, a month later than hoped

- SO provided a construction update on Vogtle Unit 3. The cold hydro testing (CHT) is done, but hot functional testing (HFT) which involves the pressurization of the nuclear reactor and first-time operations of the steam generator won't start until January 2021. That's later than we had hoped for – we had expected a 1-2 month gap between the end of CHT and the beginning of HFT thus implying a start of HFT by mid-December at the latest. The duration of HFT testing remains unclear though, for now, SO/Georgia Power expect the nuclear fuel load in April 2021. The end of HFT is widely seen as the main de-risking event for the Vogtle nuclear project so the wait continues.
- No changes to our estimates or PT for SO.

Water utilities (AWR/CWT/SJW/WTRG) - Technical trade boosting the group, especially smid caps

- We keep hearing from generalist investors that their equity strategists/internal quant screens predict a rally in stocks of US water utilities. We rarely pay attention to those comments unless they come from a couple unrelated sources and we see the recent consistent outperformance of these names which doesn't seem driven by fundamentals. We like the group based on fundamentals, even with the recent change to water revenue decoupling in CA.
- No changes in estimates or PTs for the water utilities under our coverage.

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Other Companies Mentioned in This Report

- American Electric Power Company, Inc. (AEP: \$91.95, Buy)
- NextEra Energy, Inc. (NEE: \$303.35, Buy)
- PPL Corporation (PPL: \$28.51, Neutral)
- Duke Energy Corp. (DUK: \$93.07, Neutral)
- PNM Resources, Inc. (PNM: \$49.97)
- American States Water Company (AWR: \$79.27, Buy)
- SJW Group (SJW: \$64.50, Neutral)
- Avangrid, Inc. (AGR: \$49.84, Neutral)
- NextEra Energy Partners LP (NEP: \$64.86, Buy)
- Southern Co. (SO: \$61.08, Buy)
- FirstEnergy Corp. (FE: \$33.08, Buy)
- AES Corporation (AES: \$20.49, Buy)
- California Water Services Group (CWT: \$47.96, Neutral)
- Essential Utilities, Inc. (WTRG: \$44.29, Neutral)

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